

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Electric Transmission Company LLC	:	
	:	
Application for a Certificate of Public Convenience and	:	Docket No. 02-0742
Necessity, pursuant to Section 8-406 of the Public Utilities	:	
Act, to operate as a Public Utility, and for related	:	
approvals.	:	
	:	
Illinois Power Company	:	
	:	
Petition for an Order (1) Concerning Classification of Illinois	:	
Power Company's Transmission and Distribution Facilities	:	Docket No. 02-0743
and (2) for Certain Determinations in Connection with the	:	
Sale of Illinois Power Company's Transmission System to	:	
Illinois Electric Transmission Company, LLC.	:	
	:	
Illinois Power Company	:	
	:	
Notice pursuant to Section 16-111(g) of the Public Utilities	:	Docket No. 03-0022
Act of Sale of Illinois Power Company's Transmission	:	
Assets to Illinois Electric Transmission Company, LLC	:	

Additional Direct Testimony of

Michael Gorman

On behalf of

Illinois Industrial Energy Consumers

February __, 2003
Project 7911



BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

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Additional Direct Testimony of Michael Gorman

- 1 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**
- 2 A Michael Gorman; my business address is 1215 Fern Ridge Parkway, Suite 208;
- 3 St. Louis, MO 63141-2000.
- 4 **Q ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY**
- 5 **PRESENTED TESTIMONY IN THIS PROCEEDING?**
- 6 A Yes.
- 7 **Q WHAT IS THE PURPOSE OF YOUR ADDITIONAL DIRECT TESTIMONY?**
- 8 A To respond to the supplemental direct testimonies filed by Peggy E. Carter and
- 9 Daniel L. Mortland, IP Exhibits 2.11 and 3.3, respectively.

RESPONSE TO MS. CARTER

**Q WHAT IS THE PURPOSE OF MS. CARTER'S SUPPLEMENT DIRECT
TESTIMONY?**

A Ms. Carter outlines Illinois Power Company's (IP) proposal relating to the utility's entitlement to seek rate relief during the Mandatory Transition Period (MTP). Ms. Carter represents that IP will commit during the remaining MTP that if IP's actual two-year earned rate of return on common equity (ROE) calculated in accordance with Section 16-111(d) falls below that two year average yield of the applicable U. S. Treasury securities for the same period, IP will adjust its ROE in the manner she describes that emulates the ROE that would have been realized had IP not sold its transmission assets.

 To accomplish this, Ms. Carter proposes two adjustments to IP's actual net income during the MTP. First, a net income adjustment would be made to reflect the difference between IP's projected net income with and without the transmission asset sale as included in Ms. Carter's IP Exhibits 2.3 and 2.4. These net income adjustments would also be made to IP's reported common equity balance. Second, IP would adjust its net income to reflect the difference between the projected capital expenditures IP included in its projections in this proceeding and IETC's actual capital expenditures. A similar adjustment would be made to the common equity balance reflecting this net income adjustment.

 Ms. Carter represents that after these two net income and corresponding common equity adjustments are made, IP's two-year average ROE for the two-year period under consideration would be recalculated to determine if it is still below the two-year average yield of the applicable Treasury securities for the same period.

1 **Q DOES MS. CARTER’S PROPOSED NET INCOME AND COMMON EQUITY**
2 **BALANCE ADJUSTMENT METHODOLOGY ENSURE THAT IP’S PROPOSED**
3 **TRANSMISSION ASSET SALE WILL NOT CAUSE ITS ROE TO BE BELOW THE**
4 **TWO-YEAR AVERAGE TREASURY YIELD, THUS PROVIDING IT WITH AN**
5 **OPPORTUNITY TO REQUEST A BASE RATE INCREASE UNDER SECTION 16-**
6 **111(d)?**

7 **A No.** Ms. Carter’s proposed adjustments fall far short of establishing a strong
8 likelihood that the transmission asset sale will not provide IP with an opportunity to
9 request a base rate increase during the MTP. The significant flaw in Ms. Carter’s
10 proposal is that she starts with IP’s actual net income during the MTP. IP’s actual
11 and net income during the MTP will be impacted by IP’s success or failure to comply
12 with certain objectives it sets for itself in its financial projections. The most significant
13 uncertain factor reflected in IP’s forecasts is whether it will indeed retain the net asset
14 sales proceeds to enhance its liquidity.

15 **Q WHY IS IT UNCERTAIN WHETHER OR NOT IP WILL RETAIN THE NET SALES**
16 **PROCEEDS TO ENHANCE ITS LIQUIDITY?**

17 **A IP** has not offered a mechanism where the Illinois Commerce Commission (ICC or
18 Commission) can monitor and preapprove IP’s transactions with affiliate companies.
19 If IP’s parent company, Dynegy, wishes to extract the net sales proceeds from IP,
20 while remaining compliant with IP’s commitments to the ICC concerning dividend
21 payments and affiliate loans, IP’s parent company could extract excessive amounts of
22 cash from IP through unreasonably high affiliate transaction charges. If IP is not
23 willing to agree to a plan where the ICC can oversee and preapprove the

1 reasonableness of IP's affiliate transaction charges, then there is significant
2 uncertainty as whether IP will actually retain the net sales proceeds by which to
3 enhance its liquidity. The ICC's authority to review affiliate transactions after payment
4 has been made may not ensure IP retains the net sale proceeds. Given Dynegey's
5 below investment grade credit condition and liquidity constraints, it may not be able to
6 refund charges to IP that are found excessive or unreasonable by the ICC.

7 This is particularly troublesome since IP's parent company's credit rating, and
8 liquidity situation is at least equally as perilous as IP's. It may be a matter of survival
9 for IP's parent company to extract as much cash from IP as it is able to do in order to
10 meet its own cash requirements.

11 **Q HOW WILL IP'S ACTUAL NET INCOME, AND THE ADJUSTMENTS UNDER MS.**
12 **CARTER'S PROPOSAL, BE AFFECTED IF IP PAYS OUT THE NET SALES**
13 **PROCEEDS TO AN AFFILIATE COMPANY THROUGH UNREASONABLY HIGH**
14 **AFFILIATE TRANSACTION COSTS?**

15 **A**If IP pays out the net asset sale cash proceeds to affiliate companies in the form of
16 unreasonably high affiliate transaction costs, then IP's actual net income during the
17 MTP would be reduced as a result of higher transaction expenses, and its net income
18 would also be reduced because IP would incur higher borrowing costs to replace the
19 cash that was paid out to affiliates. Accordingly, there would be a double negative
20 impact on IP's actual net income through unreasonably high expenses and borrowing
21 costs that were not expected to be incurred if the net sales proceeds are used to
22 enhance IP's liquidity.

1 **Q ARE THERE ANY OTHER ASPECTS OF MS. CARTER’S TESTIMONY YOU**
2 **WOULD LIKE TO COMMENT UPON?**

3 **A** Yes. At Page 9 of her Supplemental Direct Testimony, Ms. Carter concludes that with
4 her proposed net income adjustment commitment, there is not a strong likelihood that
5 the sale of IP’s electric transmission system will result in IP becoming entitled to
6 request an increase in its base rates during the remainder of the MTP. For reasons
7 discussed in my direct testimony, I believe even with this commitment, IP has not
8 shown there is not a strong likelihood that it will be able to request a base rate
9 increase during the MTP if it sells its transmission assets.

10 Ms. Carter has not substantiated what the purchased power costs will be in
11 2005 and 2006, and has not shown what the cost of credit enhancement will likely be
12 when IP extends its existing purchased power contracts. This increase in IP’s
13 purchased power cost will reduce its return on equity in both the asset sale and no
14 asset sale scenarios. In the no asset sale scenario, IP’s return on equity would be
15 slightly above the benchmark that would allow it to request a base rate increase
16 during the MTP. The transmission asset sale with these higher purchased power
17 costs would drive IP’s projected earned return on equity below the benchmark and
18 allow it to request a base rate increase during the MTP. For this reason, IP’s
19 proposal to sell its transmission assets should be rejected.

RESPONSE TO MR. MORTLAND

Q PLEASE DESCRIBE THE SUPPLEMENTAL DIRECT TESTIMONY OF MR. MORTLAND.

A Mr. Mortland describes a second commitment IP makes in response to Staff's concerns. Staff is concerned about IP's ability to arrange the credit security required by Illinois Electric Transmission Company (IETC) and the Midwest Independent System Operator (MISO). Together, Mr. Mortland estimates IP's security credit requirement will be approximately \$38 million at its current bond rating.¹

Q PLEASE SUMMARIZE MR. MORTLAND'S DISCUSSION OF IP'S ABILITY TO ARRANGE FOR THE REQUIRED SECURITY CREDIT.

A Mr. Mortland states that the asset sale agreement with IETC will not close if IP does not have the necessary letter of credit in place at the time of closing. Mr. Mortland states he expects that the initial letter of credit will be in effect for the shorter of one year or the remaining term to maturity of the credit agreement under which the letter of credit is issued.

Q WHAT OPTIONS ARE AVAILABLE TO IP IN ORDER TO ARRANGE FOR THE NECESSARY CREDIT SECURITY FOR ITS COMMITMENTS TO IETC AND THE MISO?

A Mr. Mortland identifies three alternatives. He states that IP's preferred option would be to have sufficient capacity under a bank Revolving Credit Agreement (RCA) backed by first mortgage bonds at the time of closing to post a letter of credit

¹ Mr. Mortland asserts IP's credit rating will be considerably lower when, or if, its bond rating improves to above investment grade.

1 pursuant to the Asset Purchase Agreement (APA). In a first alternative, if IP does not
2 have sufficient borrowing capacity under a bank RCA, he states at the time of closing,
3 IP could deposit a portion of the cash sale proceeds in a bank that would in turn
4 provide security for a bank letter of credit. In a second alternative, if at closing IP
5 doesn't have sufficient borrowing capacity under the bank RCA, and if it is unable to
6 provide sufficient security using the cash letter of credit option, IP will deposit a
7 portion of the cash proceeds from the transmission sale in an escrow account for the
8 benefit of IETC and MISO.

9 **Q HAS MR. MORTLAND QUANTIFIED THE IMPACT ON IP'S FINANCIAL**
10 **PROJECTIONS CONTAINED IN IP EXHIBITS 2.3 AND 2.4 IN ITS INITIAL FILING**
11 **TO SHOW THE IMPACT ON IP'S EARNINGS AND RETURN ON EQUITY IF IT**
12 **DEPOSITS \$38 MILLION OF THE NET SALE PROCEEDS WITH A BANK OR IN**
13 **AN ESCROW ACCOUNT AS SECURITY FOR IETC AND MISO?**

14 A No. If IP restricted \$38 million of the net proceeds to use as credit enhancement its
15 liquidity would be impacted. As such, IP would need to borrow this money if it was
16 needed for system improvements or debt retirements. This additional borrowing cost
17 was not reflected in IP's financial projections.

18 **Q HAS MR. MORTLAND OFFERED A PLAN TO ASSURE IP WILL HAVE THE**
19 **NECESSARY CREDIT ENHANCEMENT AVAILABLE TO ENSURE THAT IT**
20 **REMAINS IN GOOD STANDING WITH IETC AND THE MISO?**

21 A No. Mr. Mortland observes that the initial credit enhancement will likely only be in
22 effect for the first year. Following that first year, in order to arrange for the credit

1 enhancement he describes, IP will either have to have sufficient first mortgage bonds
2 to enable it to arrange for a new RCA, or it will have to retain cash proceeds from the
3 sale in order to securitize a letter of credit or place necessary cash on deposit in an
4 escrow account. Unfortunately, IP has not offered evidence to show that it would be
5 able to use first mortgage bonds to backup an RCA one year after the asset sale, nor
6 has it provided a mechanism that will allow the Commission to ensure the net sales
7 proceeds will be retained by IP to enhance its liquidity. Importantly, as discussed
8 above with respect to Ms. Carter, it is very possible that the net sales proceeds could
9 be extracted from IP to an affiliate company in the form of unreasonably high affiliate
10 charges. Since IP has not proposed a mechanism to allow the ICC to ensure that the
11 prices paid to affiliate companies are just and reasonable, the Commission can have
12 no assurance that the net sales proceeds will remain with IP to enhance its liquidity.
13 This is particularly important since a portion of the net sales proceeds may be needed
14 to post the cash collateral.

15 Consequently, IP has not demonstrated that it can satisfy the credit
16 enhancement requirements of the APA. Therefore, its ability to provide safe and
17 reliable service if it sells its transmission assets is problematic.

18 **Q HAS MR. MORTLAND DEMONSTRATED IT IS LIKELY THAT IP WILL BE**
19 **RESTORED TO AN INVESTMENT GRADE BOND RATING DURING THE MTP,**
20 **THUS MITIGATING THE NEED FOR CREDIT ENHANCEMENT ONE YEAR AFTER**
21 **THE TRANSMISSION ASSETS HAVE BEEN SOLD?**

22 **A** No. Consequently, I believe the Commission should assume that IP will not regain an
23 investment grade bond rating during the MTP, and credit enhancement will be

1 necessary to backup IETC obligations, MISO obligations and importantly, purchased
2 power obligations, as discussed in my direct testimony and as summarized below.

3 **Q ARE THERE OTHER CREDIT ENHANCEMENT IMPLICATIONS RELATED TO IP'S**
4 **PROPOSED TRANSMISSION ASSET SALE THAT IP HAS NOT ADDRESSED?**

5 A Yes. Mr. Mortland acknowledges in his testimony it is not assured that IP will be able
6 to put in place a letter of credit to securitize its financial obligations to IETC and the
7 MISO. Further, it is clear because of IP's current bond rating that a credit
8 enhancement is necessary for IP to contract for these services. The credit
9 enhancement requirement, given IP's below investment grade credit rating, will have
10 significant implications for IP's ability to renew its purchased power contracts in 2005
11 and 2006. If IP is unable to extend its purchased power supply in 2005 and 2006, IP
12 may not be able to fulfill its obligation to provide bundled service through the end of
13 the MTP.

14 As addressed in my initial direct testimony, in response to data requests, IP
15 stated it has not investigated whether it will be required to provide credit security to
16 extend its purchased power contracts. Further, Mr. Mortland's testimony makes it
17 clear that IP will need first mortgage bond capacity in order to enter into a RCA that
18 can be used in part for letter of credit obligations. If IP does not have sufficient first
19 mortgage bond capacity in the asset sale scenario to backup an RCA with adequate
20 capacity to support a letter of credit to both IETC, MISO and a purchased power
21 supplier in 2005 and 2006, then IP's proposed sale of its transmission assets will
22 prevent it from providing safe and reliable bundled service during the MTP.

1 Therefore, the proposed asset sale may restrict IP's ability to provide safe and
2 reliable bundled service.

3 **Q DOES THIS CONCLUDE YOUR ADDITIONAL DIRECT TESTIMONY?**

4 **A Yes.**

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